

Taking Executive Compensation Public

By Ryan Harvey and Bryan Smith

Initial public offerings have been rising significantly this year, increasing 317 percent in the first two quarters over the same period in 2009. This trend is expected to continue as more private companies prepare for market debuts. They should not underestimate the importance of making necessary changes in their executive compensation programs.

At public companies, executive pay programs are subject to the scrutiny of shareholders who often have different expectations than private investors. Market perceptions of a company's capacity to retain and motivate executives are crucial to the success of an IPO. To be competitive in the public arena, most private companies' compensation programs require significant restructuring.

Early planning is essential if companies are to act in time to demonstrate to investors the desired alignment between compensation and shareholder value before IPOs are issued. Among those involved in the planning process are human resources executives, who recommend program changes to the board of directors, and financial executives, who provide input on financial metrics and prepare for impacts on tax planning, accounting and stock-plan management.

Key areas for consideration include:

- **Competitive compensation opportunities.** The best way to assure that salaries and performance incentives are competitive with public company norms is to select an industry peer group of companies of similar size and complexity that have similar executive talent needs. Analysis of peer-group compensation levels and practices will suggest changes necessary to keep executive talent from being lured away by these competitors.

IPO companies must show investors strong links between pay and performance. This can be accomplished by tying incentives to the achievement of key per-

formance goals represented by financial metrics. These metrics should be chosen as those most likely to realize business strategies formulated to propel the rapid growth that investors want. The resulting programs can have significant tax and accounting implications.

- **Long-term incentive plan (LTI) design.** No pay element is more critical for creating sustained shareholder value. The most commonly used vehicles for LTIs are stock options, restricted shares and performance shares (shares earned commensurate with performance over a set period). Though most IPO companies use a mix of these three vehicles, stock options are most heavily weighted.

Without well-structured LTIs, compensation programs may motivate behavior that jeopardizes corporate welfare. The consequences of such behavior have become painfully evident at some companies recently, prompting more emphasis on performance-vested equity to align executives' long-term financial interests with those of shareholders.

The choice and weighting of equity components in LTIs have specific impacts on corporate financial planning. Different equity vehicles require different accounting treatments and have varying effects on shareholder dilution. Moreover, LTI vesting may have a cash flow impact.

- **Special IPO awards.** Many executives enter IPOs with significant amounts of equity incentives in place. These awards may continue to serve as incentives at the newly public company to the extent that they are converted to public stock and remain unvested.

When executives lack significant amounts of unvested equity, companies should consider special incentives known as "founders' grants." In such cases, the majority of IPOs would generally offer such grants. These grants increase contingent equity to levels typical of execu-

tives at comparable public companies, thus encouraging retention and rewarding share price appreciation. Significant unvested equity holdings upon an IPO help assure shareholders that the management team is committed to the company's long-term success.

Retention and motivation concerns aren't limited to top executives. Though less common than founders' grants, some pre-IPO companies make one-time equity grants to all or a broader group of employees as part of the transaction. And retention grants sometimes go to key employees performing IPO-specific duties.

- **Disclosure.** Going public brings significant SEC requirements for disclosure of executive compensation policies, programs and processes. In recent years, compensation-related governance has become more important to shareholders, so a thorough review of governance policies and practices is essential prior to filing the Form S-1 (the initial SEC registration form required before exchange listing).

Examples of these disclosures include: Pay decision-making processes, levels of perquisites, incentive clawback policies, severance arrangements, share ownership guidelines, anti-hedging policies and compensation risk assessment policies and processes.

Exhibiting a commitment to retaining key individuals can make a significant difference in an IPO's market reception. Such commitments impress investors all the more when they're part of a compensation program designed to build shareholder value by motivating performance for the long run.

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